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Tax Analysis

For more BEPS information, please contact:

International Tax
Beijing
Jennifer Zhang
Tel: +86 10 8520 7638
Email: jenzhang@deloitte.com.cn

Shanghai
Leonard Khaw
Tel: +86 21 6141 1498
Email: lkhaw@deloitte.com.cn

Hong Ye *
Tel: +86 21 6141 1171
Email: hoyeqinli@qinlilawfirm.com

Hong Kong
Anthony Lau
Tel: +852 2852 1082
Email: antlau@deloitte.com.hk

Transfer Pricing
Shanghai
Eunice Kuo
Tel: +86 21 6141 1308
Email: eunicekuo@deloitte.com.cn

Hong Kong
Patrick Cheung
Tel: +852 2852 1095
Email: patcheung@deloitte.com.hk

* Hong Ye is from Qin Li Law Firm, which is a licensed Chinese law firm and forms part of Deloitte's global Tax & Legal network. Deloitte Legal is one of the major legal practices around the world.

BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances

On 16 September 2014, ahead of the G20 Finance Ministers' meeting on 20-21 September, the OECD published seven papers as a first tranche of deliverables under the Base Erosion and Profit Shifting (BEPS) Project. The OECD will be continuing its work on the remainder of the 15 Actions on BEPS throughout 2015. It is clear that the G20 and OECD governments intend that recommendations under each of the BEPS Actions will form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the model tax treaty and transfer pricing guidelines. As a result, the proposed solutions in the first seven papers, while agreed, are not yet finalised and may be affected by decisions and future work on BEPS in 2015.

Deloitte comments

The inclusion (albeit provisional) of the derivative benefits clauses in the LOB rules, together with the ability for competent authorities to override the rules where there is no evidence of abuse are welcome developments, but there will continue to be practical issues for businesses seeking to determine whether the rules apply.

OECD proposals

Prevention of abuse: At a minimum, tax treaties should include:

i. a principal purposes test (PPT) rule;

ii. a limitation on benefits (LOB) rule supplemented by a mechanism, such as a restricted PPT rule, that would deal specifically with conduit arrangements; or

iii. a combined approach (i.e. including both LOB and PPT rules).

Certain targeted anti-avoidance clauses are also proposed, together with changes to the title, preamble and Commentary on the OECD Model Tax Convention to clarify that the prevention of tax evasion and avoidance, specifically including but not limited to treaty shopping, is one of the purposes of a double tax treaty.

Limitation on benefits rule: A specific anti-abuse rule is proposed based on the LOB provision already included in many US treaties. The rule is broadly designed to limit treaty benefits to companies with sufficient presence in the relevant country, based on their legal nature, ownership and activities. There are some new proposals including optional clauses on the treatment of Collective Investment Vehicles (CIVs); competent authorities' considerations for discretionary relief; and the ability to take into account regional groups (e.g. the European Union) when drafting clauses. There are also proposed amendments to the Commentary on the OECD Model Tax Convention, such as discussion of what constitutes an 'active business' for the purposes of LOB, which indicates that a company functioning solely as a headquarters company could have difficulties in meeting the test.

LOB **–** derivative benefits clause: The LOB proposals provisionally include a 'derivative benefits' clause, which would allow a treaty country to look through to the shareholders where the shareholders would also be entitled to benefits under a treaty. Negotiating states would be given the flexibility to restrict the clause to dividend income. The inclusion of the derivative benefits clause is based on an assumption that other BEPS Actions will address specific concerns which may arise from its inclusion, and this will therefore be re-examined in 2015.

Principal purposes test rule: The paper proposes a broadly drafted general purpose rule aimed at removing treaty benefits where one of the principal purposes of arrangements or transactions is to obtain treaty benefits.

Determining treaty residence: The existing 'place of effective management' tie-breaker clause for determining treaty residence is to be replaced by a requirement that the competent authorities of the two countries endeavour to determine residence. Countries which share the view that the 'place of effective management' rule was not being abused can continue to use it.

Minimum shareholding period re dividends: Reduced rates of withholding tax applicable to non-portfolio dividends will be restricted to shareholdings that are owned throughout a 365-day period that includes the date of the dividend payment. The recommendation also states that: "… for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend". It is unclear from the report how this rule should be applied; clear guidance concerning the correct application of the stipulated rule would be welcome.

Withholding taxes on payments to permanent establishments: There will be restriction of relief from withholding taxes on payments to a permanent establishment in a third country with a low rate of tax, where the permanent establishment's profits are exempt from tax in the resident country.

Timetable

Further work will be undertaken in 2015 ahead of the multilateral instrument to implement changes, in particular in respect of the treatment of CIV and non-CIV funds, and on the implementation of minimum standards.

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

Beijing
Kevin Ng
Partner
Tel: +86 10 8520 7501
Fax: +86 10 8518 7501
Email: kevng@deloitte.com.cn

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Shenzhen
Sarah Chin
Partner
Tel: +86 755 8246 3255
Fax: +86 755 8246 3186
Email: sachin@deloitte.com.hk

Chongqing
Frank Tang
Partner
Tel: +86 23 6310 6206
Fax: +86 23 6310 6170
Email: ftang@deloitte.com.cn

Jinan
Beth Jiang
Director
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: betjiang@deloitte.com.cn

Suzhou
Frank Xu / Maria Liang
Partner
Tel: +86 512 6289 1318 / 1328
Fax: +86 512 6762 3338
Email: frakxu@deloitte.com.cn
mliang@deloitte.com.cn

Dalian
Frank Tang
Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: ftang@deloitte.com.cn

Macau
Sarah Chin
Partner
Tel: +853 2871 2998
Fax: +853 2871 3033
Email: sachin@deloitte.com.hk

Tianjin
Jason Su
Partner
Tel: +86 22 2320 6680
Fax: +86 22 2320 6699
Email: jassu@deloitte.com.cn

Guangzhou
Sarah Chin
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: sachin@deloitte.com.hk

Nanjing
Frank Xu
Partner
Tel: +86 25 5791 5208
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn

Wuhan
Justin Zhu
Partner
Tel: +86 27 8526 6618
Fax: +86 27 8526 7032
Email: juszhu@deloitte.com.cn

Hangzhou
Qiang Lu
Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn

Shanghai
Eunice Kuo
Partner
Tel: +86 21 6141 1308
Fax: +86 21 6335 0003
Email: eunicekuo@deloitte.com.cn

Xiamen
Sarah Chin
Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: sachin@deloitte.com.hk

About the Deloitte China National Tax Technical Centre

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National Tax Technical Centre
Email: ntc@deloitte.com.cn

National Leader
Leonard Khaw
Partner
Tel: +86 21 6141 1498
Fax: +86 21 6335 0003
Email: lkhaw@deloitte.com.cn

Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Southern China (Hong Kong)
Davy Yun
Partner
Tel: +852 2852 6538
Fax: +852 2520 6205
Email: dyun@deloitte.com.hk

Southern China (Mainland/Macau)
German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Eastern China
Kevin Zhu
Director
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.